How To Be Your Own Developer

The Neighborhood Reinvestment Training Institute Community Revitalization Series

Real Estate Development Tools

How To Be Your Own Developer: Making the Development Decision
Introduces nonprofits considering real estate development to the basic steps in the process.

Real Estate Development Step by Step: A Guide for Community-Based Organizations
Walks nonprofits undertaking a first-time development project through and offers guidelines to more experienced nonprofit developers.

Lending Tools

Mortgage Lending: An Introduction for Community-Based Organizations
Reviews the mortgage lending industry, including steps in the lending process and cooperative lending arrangements.

Loan Origination: A Workbook on Gathering and Verifying the Information
Covers originating and processing a loan application.

Loan Underwriting: A Workbook on Analyzing and Committing to Lend
Covers underwriting, presenting to a loan committee, and committing to make a loan.

Loan Closing: A Workbook on Executing the Documents and Transferring the Funds
Covers creating the legally binding agreement between lender and borrower.

Neighborhood Reinvestment Training Institute
Community Revitalization Series: Real Estate Development Tools

How To Be Your Own Developer

Making the Development Decision

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Foreword

In the last decade, many nonprofit, community-based organizations have become real estate developers. In its latest survey of the achievements of community development organizations, the National Congress for Community Economic Development found that these locally based groups had developed nearly 320,000 units of housing. Some of these groups have simply rehabilitated one or two vacant houses afflicting a particular block, but more than 400 groups are medium- or large-scale real estate developers that have completed 100 or more units of affordable housing. In many communities, these nonprofit developers are the most significant force in the effort to revitalize older neighborhoods.

Whether an organization seeks to increase the number of affordable housing units available to local residents, redevelop problem properties that prevent neighborhoods from revitalizing, or spark others' reinvestment in neglected areas, guidelines for development are essential. *How To Be Your Own Developer can* provide you with these guidelines, as it has for community-based organizations across the country, who have used 10,000 copies of the original guide since 1989.

This revised edition of the popular guide goes to press at a time when many more nonprofits are considering becoming housing developers. More than ever, board members of such groups should be equipped to actively participate in decisions about housing development. *How To Be Your Own Developer* will introduce new players to the basic concepts and steps and the functions of the various professionals involved in the process. For those already familiar with the process, the guide offers a framework for reviewing the issues and structuring the decision-making process.

This second edition has benefited from extensive revisions provided by Al Tetrault (Tetrault Associates, Washington, D.C.). His 25 years of experience developing affordable housing have contributed to sharpening the text, along with adding new cautions and encouragements.

The concepts and methods discussed in this guide are examined more intensively in a variety of courses on real estate development and management at the Neighborhood Reinvestment Training Institute, where thousands of staff and board members each year share experiences and learn new skills. Courses include Affordable Housing Development, Financial Feasibility Analysis, Low-Income Housing Tax Credits, Project Management, Design Quality in Affordable Housing, and The Real Estate Game.

Real estate development, full of risks, can also produce tremendous rewards. If you decide development is for you, be sure to read this guide's companion, *Real Estate Development Step by Step: A Guide for Community-Based Organizations,* which will walk you through the process in greater detail.

Washington, D.C. Gary Askerooth
April 1994

Series editor Gary Askemoth, who has developed and built housing in Illinois, Minnesota, New Mexico, and Ontario, is associate director of training at the Neighborhood Reinvestment Corporation.

Objectives

This guide is designed to help you, the community-based organization:

- assess the feasibility of a development idea and your own readiness to take on such a venture, in terms of your capabilities, community support, and availability of funding;

- decide which capabilities your organization has and which you would have to hire if you were to tackle a development project;

- understand the basic components of real estate development: goal setting, market analysis, site selection and inspection, financial feasibility analysis, financing packages, product design, construction estimating and monitoring, marketing, sales and leasing, and property management.

Chapter 1
Is Your Organization Ready?

Why do you want to be a real estate developer? Are you aware that professional developers who have been in the business a long time still occasionally get burned on bad deals? Most have other projects and reserves to see them through a failure-but you may not. Experienced developers also occasionally encounter vigorous community resistance to their plans or products. Is it appropriate for a community-based nonprofit organization to clash with its community?

Good developers are aggressive entrepreneurs.

Real estate developers have been defined as "imaginative risk-takers." They see a site and perceive an opportunity for profit. But good developers, who have an excellent grasp of both the big picture and the details, don't take risks based on imagination alone. They balance the dreams of a project with a careful analysis of its risks, and take the project on only if the balance tips well in favor of success.

Community-based organizations can be successful developers in their communities, as has been proven in many cities and rural areas. But before you decide to plunge into real estate development, spend plenty of time defining what you want a development project to achieve and assessing your organization's abilities to achieve it. Begin by setting your goals.

Setting Your Goals

You may want to go into development because you and others in your organization imagine what the neighborhood you serve could be, and you can identify some properties that need to be altered to fit your vision. Or funding sources may be asking you to undertake a specific project or move, in general, into development.

The first thing to accept is that there maybe good reasons why some properties have not already been developed. Successful for-profit developers are aggressive entrepreneurs who constantly analyze development potential as they drive by vacant sites. Sites in your community may remain vacant because of developers' ignorance or prejudices about the market. On the other hand, some very careful and open-minded developer may have analyzed a site you have in mind and rejected it because, for some reason, it did not fulfill his or her profit objectives.

You, too, need to analyze potential projects in terms of your own goals. It may take a series of meetings to work out why you want to undertake a project and clearly define your objectives. Questions to consider include:

■ Is your main goal to provide income to your organization? Would you still be interested in the project if it generated no income?

■ Is your main goal to improve a particular property because it is an eyesore that detracts from the marketability of the neighborhood?

■ Is your main goal to provide much-needed housing opportunities for low- and moderate-income people in your community?

■ Is your main goal to complete your work (of which this project is the last step) in the target neighborhood?

■ Is your main goal to stimulate the revitalization of the area and encourage more investment?

If you discover that you have multiple goals, hold frank discussions to rank them and define your organizational commitment to quality; you will need the context this provides to reach decisions later, when the goals inevitably conflict. For example, if your goal is to provide low-income housing, you may need to adopt a strategy of keeping construction costs as low as possible, while still meeting your quality standards. If you come under pressure to do an intricate multicolor paint job, for instance, it will be easier to decide whether or not to do it if you have agreed on your number-one priority. If, on the other hand, your primary goal is to spark other reinvestment in the neighborhood, the exterior treatment of the building is crucial. Painting a brick facade may be cheaper than chemically cleaning it, but your goal may be better served by budgeting the extra money to clean it.

You will face many choices as you develop your product. If your top priority is to rid the neighborhood of an eyesore, you may decide to develop market-rate housing instead of building deep subsidies into your financing. The finished housing may be out of reach for lower-income residents of your community, but if your overriding goal is to treat the building as soon as possible. market-rate housing maybe the most efficient way of achieving it.

These are just a few examples. Your goals will affect every stage of the project, so it is extremely important to take time at the very beginning to build consensus. If you cannot reach unanimous agreement, it does not mean that you cannot go forward with the project, but it does mean that you may encounter battles later on. If you can refer back to a planning meeting in which you established priorities, you will weather any storms better.

Nonprofits' decisions to act as developers have been known to create schisms in communities and within organizations. Board members have quit in anger and residents have picketed the nonprofit's office. These are extreme examples, but they happen-usually because the nonprofit has failed to plan or has misread the community. So spend a lot of time (it could take up to a year) testing the waters and setting your priorities. When you are confident that you have defined your goals as best you can and garnered community support, focus on your organization's ability to achieve the goals you've set.

Assessing Your Abilities

Again, hold a series of meetings to openly discuss your organization's staff, systems, and finances and the skills required to achieve your goals. Assess your organization's abilities (including its ability to change) based on your goals, which may fall into two categories: project-specific and long-term development.

Project-Specific (Short-Term) Development

If your goal is to rid the neighborhood of a specific eyesore or take the last step required to complete a target area, then your organizational assessment maybe easy and any changes may be minor. But even this short-term, one-time only involvement in real estate development will affect your organization's operations. Questions to ask regarding your abilities to handle short-term development include:

Even a short-term development project will **affect your operations.**

■ Do board and staff members have the skills necessary to start and complete this development? Can board and staff members be relied upon to devote the time necessary to complete this new venture?

■ Will this development positively or negatively affect existing services or operations?

■ Can you complete the development project by hiring outside consultants and professional services? If so, who will make the decision to secure these consultants and services and how will they be managed?

■ Can your organization reduce its involvement through a joint venture with an experienced developer? Can your organization contribute the land, building, cash, or grant funding that can make the project attractive as a joint venture?

■ Does your organization have adequate internal operating systems to manage the proposed project? Can you easily alter existing systems, or would you need to develop new systems?

■ Does your organization have the necessary start-up capital and are you willing to lose it if the project fails?

If the discussion generated by these questions indicates that the development project is within the scope of your organization's skills, abilities, and systems and that your organization is willing to accept a possible reduction or temporary elimination of its usual services, then you can begin to analyze the project's feasibility.

Alternatively, if the skills this project would require differ significantly from your organization's expertise, or your accounting, communications, and management systems are not adequate to manage this type of venture, you can often still undertake the project by selecting and hiring a competent consultant and professional services. Assigning the negotiation of contracts for services and the supervision of consultants to a specific staff or board member will keep the project from unduly interfering with your usual operations.

General (Long-Term) Development

If your main goal is to generate income, provide housing opportunities for low- and moderate-income people, or trigger other revitalization efforts, then it is important to recognize that you aspire to become a real estate development company. To achieve this goal, your organization will have to make significant changes and may even need to establish a new organization. Questions to ask regarding your financial, organizational, and staff abilities to handle long-term development include:

Long-term development requires significant organizational changes.

■ Does your organization have the necessary capital to get a project off the ground and see it through to completion? And, most importantly, are you willing to lose this capital if the project fails or you decide to withdraw?

■ Will you need to secure new or additional office space or equipment? Do staff have the necessary skills to operate the new equipment or will they need to be trained?

■ Are your internal operating systems designed for project-based record keeping? Is the current accounting system organized to provide information on a daily basis?

■ How will you structure the development project to best achieve your goals? Will it be nonprofit or for-profit a partnership, a corporation, a subsidiary, or some variation on these forms? If you develop a new organization, what will its relationship be to the "old" organization?*

** These questions are complex and change with each project and are best decided in consultation with legal and tax counsel.*

■ What skills do staff members have and what skills will this new venture require? Are staff members entrepreneurial? Do they take risks? Do they possess the technical skills and the drive, ego, experience, and knowledge to see a development project through to completion?

■ If your organization requires additional staff to meet its goals, will you establish a reward system (including bonuses, incentives, profit sharing, or gain sharing) to approximate private marketplace compensation and encourage entrepreneurial behavior? If compensation for development staff differs from that for existing staff, will this negatively affect staff performance?

■ How much authority will staff members possess to obligate your organization financially? Will you set a limit of $1,000? Of $1,000,000?

Additionally, successful real estate development requires tight control and unflinching decisiveness, both of which limit board participation. With possibly millions of dollars at risk, success often relies on quick and sometimes "secret" decisions. (Acquiring multiple sites from different owners on the same block, for instance, is likely to be much more expensive if the owners all know you want their properties.) The open and often lengthy decision-making process favored by many community-based organizations adds time to a development schedule and can significantly increase the development's cost. Community-based organizations that venture into development can encounter great diffiiculty in balancing time and money considerations against a commitment to community participation, and this issue often generates heated discussion among an organization's board and members.

Skills You Need to Have or Hire

At the most basic level, the developer is the person who has the idea, then matches a property with an income-producing scheme. To bring that idea to fruition, however, requires amassing the talents and skills of a number of professionals, including:

■ appraiser;

■ land developer;

■ accountant;

■ tax expert;

■ inspector;

- market analyst;
- architect;
- attorney;
- financier/lender;
- syndicator;
- contractor;
- planner;
- sales agent;
- property manager;
- engineer (civil, structural, mechanical, and environmental).

Most successful developers have general knowledge of all these areas and specialized expertise in one or two. They hire professionals to assist with certain stages of the development process.

Updating Your Business Plan

Your organization should already have a business plan that identifies its objectives, management, personnel, product or services, market, customers, competition, risks, and financing. Before beginning a development project, you need to update the plan. This will require significant board time even if you assign existing staff, retain consultants, or hire new staff to develop the business plan. The plan should identify three things: the new marketplace; your organization's new mission and objectives; and the product and services to be offered. Additionally, you will need to perform a market study that examines the customer, the competition, and the risks, and develop pricing, selling, advertising, promotion, and public relations strategies. Finally, you must develop budgets, income statements, cash flow projections, break-even analyses, and sources and uses of funds statements. Only after your organization develops, approves, and finances a business plan should it proceed with a development project.

Any organization considering a one-time projector gearing up for full-time development activity should understand the real estate development process. Although this guide treats each step in the process as discrete, in practice developers perform many functions simultaneously, and nonprofit organizations must consider the implications of this for their own staffs. The following chapters outline the approximate sequence of events in the pre-development, development, and post-development phases of the process.

Chapter 2
Pre-Development: Project Planning and Feasibility Analysis

Careful planning and preliminary work can make or break a project. The steps this chapter outlines should lead you to a sound decision about whether or not to proceed. What the outsider sees as development is often just the construction phase, but the pre-development phase of a project consists of a number of components and is often the longest of the three phases, taking up to 50% of the total time of a project. After you have set your goals, the next step-the first step of the pre-development phase—is selecting a site or sites.

Selecting Sites

If your primary goal as developer is to rid the neighborhood of a specific vacant property or properties, you will engage in no selection process. If, however, your goal allows some choice among sites, then you will analyze various locations before or as you begin a market study.

Developers look for sites that fit their profit objectives. The two main considerations for residential developers are whether they are in the multifamily or single-family business and whether they want to sell the projector keep it. Sites that are appropriate for home-ownership development may not work at all for rental housing.

Pre-development is often the longest of the three phases of a project.

Small developers tend to specialize in a geographic region as well. It takes some time to understand the market dynamics of an area and to master such practicalities as how to get permits expedited through a county or city government. Ideally, developers pick a site that maximizes profit opportunities within a region they know well. Neighborhood organizations, unless they have a city-wide focus, already specialize in a certain area. Your task as a community-based developer is to choose the site or sites that best achieve your goals.

The basic guidelines in property selection apply whether the goal is to provide affordable housing, spark reinvestment in a target area, complete the revitalization of an area, or something else:

■ *Contiguous properties are easier and cheaper to work with than scattered sites.* There *are costs* involved in moving supplies and tools from site to site and in providing security for scattered sites during construction. Additionally, financing for scattered-site development under a single loan is difficult to achieve, ownership is complex, and legal costs are disproportionately high.

■ *A concentration of development activity within contiguous blocks has a visual impact that encourages other reinvestment.*

■ *The cheapest properties are not necessarily the cheapest properties.* Experienced developers are wary of apparent bargains. Low prices often point to significant and potentially costly physical or environmental problems with property.

■ *Acquiring properties can be* **enormously time** *consuming, thereby adding to the costs of the project.* It often makes sense to go with properties you know you can acquire easily rather than to set your sights on "choice" locations held by stubborn or irrational owners. Dealing with a difficult property owner can delay a project by years. But be careful not to choose a property that lacks strategic consequence just because you can get site control.

Analyzing Sites

Once they have a site (or sites) in mind, whether vacant land or buildings, developers check that the zoning will allow what they have in mind and perform a preliminary inspection to determine if any conditions exist on the site that could lead to extraordinary development costs. Developers know current development costs for the "average" unit and need to know whether to budget extra amounts in their pro formas. Getting zoning changed also requires extra time and money.

One piece of land may cost twice as **much to develop as another.**

One piece of "raw" land may cost twice as much to develop as another. Before developers **secure** financing they will order engineering and environmental surveys, but at this point they can usually spot potential problems. Factors to consider include size and shape of the property, access to main roads and utilities, grading, drainage, composition (is it all rock, for instance?), and the condition of the surrounding area.

A phase one environmental study needs to be completed by a certified engineer as soon as possible, preferably before acquisition. Land sites can harbor radon, hydrocarbon pollutants, or other environmental problems. Rehab projects also require environmental studies to test for the presence of a variety of pollutants. Strict federal regulations require that three substances-asbestos, lead-based paint, and PCBs (polychlorinated biphenyls)—be removed or encapsulated. A number of building materials contain asbestos, including insulation around

heating pipes and inside walls, floor tiles, some types of plaster, and exterior siding. Most structures built before 1978 contain lead-based paint. Old electrical transformers on large multi-unit projects often contain PCBs. The presence of any environmentally harmful substance can significantly increase a project's cost.

On rehab projects, developers look for structural flaws that are expensive to repair. They view the entire block for such signs of potential trouble as:

- tilted houses;
- sunken sidewalks and other signs of erosion;
- bulges, crumbling block, loose bricks, split wood, and popping nails, all of which point to stress in building facades;
- leaning chimneys;
- indentations and humps in roofs.

Inside the property, things to look for include:

- cracks and breaks in the foundation;
- signs of flooding or water damage;
- signs of termite damage;
- cracks in walls;
- condition of basic systems (plumbing, electrical, and heating and air conditioning).

They also note the location of load-bearing walls, which could affect the cost of layout changes.

Experienced developers are not engineers, designers, or estimators. They are, however, confident of their ability to "ballpark" costs and identify potential problems, because they have looked at a great deal of land and many buildings overtime. If no one in your organization possesses this experience, you need to hire or borrow someone who does very early in the process, in order to perform some preliminary cost projections.

If, after the market study, the developer decides to go ahead with the project, a more extensive inspection will be made. The developer's purposes in the initial inspection are to judge the suitability of the site for the imagined project and spot potential problems.

Analyzing the Market

The goal-setting process helps you define the population for whom you are developing the housing, be it low-income renters, new homeowners, or another group. The project-specific market study and analysis helps you determine whether a demand exists for housing in your neighborhood among that population or if one could be stimulated. It also helps you determine what to charge for the rental or sale of that housing.

A market study need not result in a glossy, 30-page document prepared by an "outside expert," although such a document is useful for making proposals to lenders and investors. The developer who has been operating in a particular geographic area for some time is constantly accumulating market data, as are many nonprofit community organizations. The main objective is to organize and interpret the data in away that allows you to make projections about rents, sales prices, and buyers and convince a lender or investor that the risk is worth taking and supported by facts.

Market Data

The market study should include information on several aspects of the neighborhood and its people, including those discussed below.

Population

Developers usually target the population that already lives in the area.

Most conventional developments target the type of population that already lives in the area or has shown preference for it by moving there. (If, as a developer, you plan to appeal to an entirely new kind of buyer, you will need quite an elaborate marketing strategy to succeed.) Market studies, then, begin by analyzing the current residents. Information to gather includes:

- who lives in the neighborhood;
- residents' occupations and incomes;
- residents' mobility (people moving into or out of the neighborhood-movement is much greater among renters than homeowners);
- average ages and family sizes.

The age distribution of the population also has potential implications for development. In many older urban neighborhoods, for example, a large portion of residents are under 30 and a large portion are over 60. The older residents most likely own their homes and the younger ones may lack the resources to purchase homes.

As a neighborhood-based organization that knows its neighbors, you are in an excellent position to have this information. Other sources include census data and planning department reports. For a fee, the census bureau will send you information on whatever neighborhood you specify. In many areas, regional planning councils or planning departments also have organized census data by neighborhood, zip code, or census tract; check and see if this is the case for your area.

Home-ownership percentages

This includes the percentage of housing that is owned by homeowners as opposed to investors and whether this percentage is increasing, decreasing, or stable. This is excellent information for any housing organization to possess, whether or not it is in the development business. Many planning departments maintain this information and will share it with community-based organizations. In other areas, you can often gather this data by going to the tax assessor's office and checking where and to whom tax bills are sent. If tax bills are sent to an address other than that of the subject property, that usually indicates an investor-owner.

Vacancy rates

In addition to the percentage of units that are vacant, this includes the degree to which residents double up and share units (possibly indicating that rents maybe too high or that too few units exist). Again, your own contacts with residents plus a block-by-block visual survey of the neighborhood are the best sources of information. Census data can back your primary research.

Sales and rental data

This includes average sales prices and rental rates, whether significant variations exist between what houses list for and what they ultimately sell for, the length of time units stay on the market before being rented or sold, and the local standards for a rental contract (for example, first and last month's rent, cleaning deposit, key deposit, and a one-year lease; or one-month rent deposit and a month-to-month lease). Sales data should be compiled systematically and tracked showing list price, listing date, sales price, sales date, and final closing information.

For an annual fee, you can access the online sales data available in many areas. Records at the county offices of the recorder of deeds also contain sales information, and many cities publish real estate directories monthly. The loca**Board of Realtors' multiple listing service** (MLS) contains all the sales data. Realtors in the Washington, D.C., area are introducing

anew service that will likely become widely available: a computerized database of all properties listed in the metropolitan area, accessible directly by telephone. Callers who are merely seeking listing information need not contact a realtor at all. Rental data maybe available from a local property owners association. Organizations need to follow newspaper listings as well.

Competition

This includes whether other development ventures in the area may compete with your venture, what their products are, who their markets are, and how they are doing. Though you can gain some information by watching your competitors' advertising, you can also visit the project and ask the sales or leasing agents directly. If you goon a slow day such as Monday, they are likely to tell you frankly how leasing or sales are going, even if you identify yourself as a potential competitor.

Talk to city planners about possible sites.

Also investigate what developments may be imminent. Spend some time in the permits or zoning office checking on relevant applications. Speak with city planners to find out what they know about key parcels of land, vacant warehouses, or other possible development sites in the neighborhood. Many developments have suffered when competing projects entered the market at the same time.

Amenities

This includes the schools, shopping areas, churches, parks, playgrounds, hospitals, and other community services available in the neighborhood; any special historical or architectural features; adequate public transportation; and the quality of the civic spaces and the scale of buildings. Amenities also include such considerations as whether it is easy to walk places and whether trees flourish. Also note in this section not only statistics on crime, but perceptions of crime-whether, for instance, people believe the crime rate is higher or lower than it actually is and whether or not people feel safe in the neighborhood.

It maybe worthwhile to conduct a historical study of your neighborhood. Local historical commissions will usually help you get started on such an effort, which may result in useful marketing angles for your project.

Data about amenities is crucial for determining value. Lenders, as well as your potential renters or buyers, will require this kind of reassurance.

Purchasing power

Though strictly speaking this is not part of the market study, you need current information about the mortgage market and economic forecasts. The best-built units will sit empty if your target population cannot afford the going interest or rental rates when the project is completed.

This is a high-risk area for conventional developers, who must predict where the economy is going to be in two years when their houses come on the market. Nonprofit housing groups and for-profit developers of subsidized housing can reduce their risk by obtaining grants or other public financing which, blended with private financing, can produce mortgages or rents virtually certain to be below market rates.

It is important to analyze the purchasing power of your target population, taking into account employment trends, income projections, interest rates, and types of mortgages to be available. This will help you decide to what degree a subsidy maybe necessary.

Projections and Pro Formas

Current market data and trends help the developer create a picture of where the market will beat the completion of the project. Most developers will not undertake projects they cannot finish in one or two years. Both cash flow and market projections become precarious after two years, and the longer the projections extend, the higher the risk is that they will be incorrect. The market study may deal with a five-year period encompassing the current market, the situation for the past two years or so, and projections about the next two years.

The projections about future trends figure significantly in assessing a project's risks. Developers use a market study's projections about future trends to develop the pro formas. For example, the three most commonly projected items on an income and expense pro forma for a multifamily rental project are the annual rate of income increase, the annual rate of expense increase, and the vacancy rate. Many pro formas assume a **4%** annual rental income increase, a **370** annual expense rate increase, and a 5% vacancy factor as "plugs." Using "plug" amounts may be useful in working up preliminary pro formas, but more precise projections are essential for final pro formas. If your rents are limited by regulation or program requirements, a **4%** annual increase may not be appropriate or even allowable. If your market study shows that rents have been flat or increasing by only 1% per year for the past three years, your projections should reflect that information. If the area vacancy factor has been 8%, again, this should be reflected. Projections are affected by and should reflect historic patterns identified in your market study. If they don't, your market study should explain why—for example, you project increased housing demand because of an increase in jobs.

At this stage in the process, it is enough to have all this market information in files in your office, in accumulated real estate sales reports, or in your head. You are using it to decide whether or not to proceed with the project, not to make a formal presentation. As you seek financing, though, you will need this information in document form. Even if you made your decision "seat of the pants''—with your intimate knowledge of the neighborhood-you will need to organize your market data in a narrative.

Setting Prices

There are three approaches to setting sales prices or rents for a development.

Optimist Method

The optimist method bases the price on the amount needed to recoup the costs of buying the land and building the buildings and other development costs. If the developer is lucky, the price turns out to be within what the market will bear. If the set price turns out to be higher than the market will bear, the developer has a problem.

There are **three basic approaches to setting** sales **prices or rents.**

Back-Out Method

The back-out method bases the decision to undertake the project on the price the market will bear. The developer does a market study to determine what price people will pay for a particular unit, compares that to the estimate for the land, construction, and development costs, and proceeds with the deal if the going price is greater than the cost. Although this approach is not foolproof either, it attempts to reduce some of the inherent financial risks of development.

Regulatory Method

This method establishes the sales price or rental rate by regulation. Using programs with specialized or restricted funding, the nonprofit developer then "backs out" the project based on the regulated prices. (For example, rents maybe limited to 60% of the area median income.) A market study should identify whether or not an adequate number of "program-qualified" households exist and may be attracted to a development in this area.

Designing the Product

The goals you hammered out in your initial meetings create a framework for setting design goals for your product. You may do this before you hire an architect or with the architect you hire. Every project is also subject to a number of variables that influence and shape its design, including:

■ function (single-family housing has different requirements than a multifamily development that includes a day-care facility, for example);

■ site (including such physical characteristics as size and configuration, as well as environmental factors, adjacent land uses, and other considerations);

■ codes and regulations;

- cost;
- schedule.

Based on information provided by the market study, the developer adjusts the initial concept of what the product is and begins rough plans and sketches. The market study may point to the need for a different mix of numbers, sizes, and types of units to meet the needs of the potential market (more one-bedroom than three-bedroom units to serve a large population of single people, for example). Your design goals will help you reach decisions when conflicts arise-for example, between cost and quality. You will also want to remember that whatever you build you will have to own or manage for up to 50 years, in some specialized programs, so design and quality will have a major impact overtime.

Other elements of the market may affect the product design. If the market study identifies crime as a problem, for instance, you could change the design to include more exterior lighting, higher visibility entrances, and security systems. If the market study determines that public transportation is limited, inefficient, or nonexistent, the automobile becomes a major design issue, requiring the product design to address parking, traffic flow, and visibility of and easy access to cars from the units. Alternatively, you could obtain a commitment from public agencies to support car pooling or shuttle service to public transportation.

The **best** designs are the ones that exhibit the greatest degree of site awareness, taking fully into account current, traditional, and planned use, on the one hand, and physical condition and cost on the other. Placing housing on a vacant lot just so it will no longer be vacant is not a good reason to develop housing. Carefully consider context of use, so that the physical possibilities derive from the habits and needs of residents.

Estimating Project Costs

Based on product design, the developer begins to estimate the total cost of the project (see the sources and uses statement on p. 30). As a housing organization, you may have cost information for the construction costs (hard costs) section in-house because you have a rehab estimator or someone who knows new construction on your staff. If you do not have this knowledge, talk with a couple of builders or contractors who have done the kind of work you are planning to do. Most builders will be willing to estimate some costs for you now in hopes of getting the job from you later.

Analyzing Financial Feasibility

At this point in the process, you will produce a preliminary financial feasibility analysis, the first in a series of pro formas. (As you refine each number-for example, with more exact costs-you will revise the calculations.) These initial calculations allow you to determine the kind of financing and sort of subsidy, if any, the project will require. Using your knowledge of current conventional financing terms and the availability of public subsidies, you must then make a judgment about the feasibility of the project.

A very simple and general calculation for evaluating the financial feasibility of a project starts with what your target population can afford (the back-out method). The following "thumb-nail" calculation for a rental project tells you whether the debt your rents can support (line H) will cover the project development costs (line I). If line H is greater than line I, there may be cash left over (potential profit). If line I is greater than line H, you will need to consider whether you can obtain a grantor subsidy to cover the shortfall.

The following example is based on the Fern Hill project, an imaginary 16-unit acquisition and renovation project.

Preliminary Financial Feasibility Analysis: Rental Project

A. Projected average rent payment	$425
B. Number of units you are constructing	16
C. Your monthly cash available (A x B)	$425 **x** 16 = $6,800
D. Your yearly cash available (C x 12)	$6,800 X 12 = $81,600
E. Your yearly taxes, insurance, maintenance, repairs, and other expenses. (Use the industry rule of thumb of $2,200 per unit per year.)	$2,200 x 16 = $35,200
F. Portion of your cash available to pay off the property's debt (D -E)	$81,600- $35,200 = $46,400
G. Your monthly cash available to pay off debt (F ÷ 12)	$46,400 ÷ 12 = $3,867

H. Amount of debt your project will support (On a financial calculator, enter G, the current market interest rate, and current length of loan-in this case, 7.25% and 20 years-and solve for the principal amount.)		$489,218
I. Total project development costs (from the Fern Hill sources and uses statement, p. 30.)		$816,197
J. Amount of equity, subsidy, or grants needed (I - H)	$816,197-$489,218 =	$326,979

When calculating the feasibility of a for-sale project, consider whether the mortgage loan someone in your target market can afford is larger than your development costs per unit. If not, you' 11 need to assess your chances of securing a subsidy or other financing to cover the difference.

Both rental and for-sale projects also require built-in "cushions" of up to 25% of development costs against the costs of construction delays, cost overruns, vandalism, slow sales, and other contingencies of development.

When you take all the available information into consideration, these preliminary calculations provide another element for you to weigh when deciding whether or not to pursue a venture. *

Deciding on the Project: Go/No Go

Dropping a project after the pm-development phase can be very costly.

When your market study and preliminary financial feasibility analysis are complete, you should be very clear about who your target population is, what their housing preferences are, and how much they can afford to pay in rent or monthly mortgage loan payments. You will also have a rough idea of what your product would look like, how much it would cost you to produce, and how it can be financed.

This is the point at which you review the risks, determine the likely rewards, and decide whether or not to proceed. You can decide to drop a project at any time in the development process, but dropping a project after this point can be extremely costly. If you decide to proceed, you now move into the second phase of the process: the development phase. The next chapter covers the major elements of this phase.

** For examples of the more detailed financial analyses and pro formas lenders require, see another guide in this series,* Real Estate Development Step by Step: A Guide for Community-Based Organizations.

Chapter 3
Development: Project Financing and Construction

The development phase includes land or building acquisition or control, financial commitments, and construction. This is the best point at which to develop a project schedule, which is used to determine the time required for building the product and closing the financing. (See the sample project schedule on p. 31.)

Acquiring Property

The moment of truth has come and you have decided to move ahead with the project. It is wise to begin to get some control over the property or properties you will need. How this is done, of course, depends upon the type of property and the market conditions. Residential projects can be divided into two types, scattered-site and single-site, each requiring a different acquisition strategy.

Scattered-Site Properties

Probably the most difficult properties to acquire are scattered lots or houses in the hands of different, private owners. Typically these houses, if vacant, have been sitting a long time and would seem ripe for purchase; but the owners, once you find them, are often difficult to deal with.

Scattered-site properties are the most difficult to acquire.

To try to acquire such properties, ask the city to begin to apply whatever pressures it can to help get the owners in the mood to sell. These pressures can range from inspectors stepping up the flow of violation notices to the city beginning condemnation procedures. If you use this strategy, stress to the city how important it is to get moving early. Many projects have been seriously delayed because the developers could not get control of the property.

Later in the process, when the funds become available for you to purchase the properties, you need to exercise extreme care. If owners sense that a big project is afoot, their prices may go up. Many nonprofit organizations avoid this problem by having several people, perhaps cooperative real estate agents, purchase the properties quietly and transfer ownership to the housing organization. Another strategy is to have a local landlord you know and trust purchase the properties for you, as this will arouse less suspicion.

Single-Site Property

If you want to develop a single large building or vacant parcel of land, you will probably first purchase an “option” by paying the owner a fee to take the property off the market for a period of time, say six months or a year, while you line up financing. The owner agrees that during the option period you can purchase the property for an agreed-upon price. The option also stipulates your right to withdraw your offer if you cannot secure financing, necessary zoning variances, satisfactory results from soil, engineering, or environmental tests, or other contingencies.

Local brokers or lenders can advise you what to pay for an option. In some places, $1,000 is typical for a tract of land, but in other areas, determining the price can be complicated. One easy, popular formula bases the option price on the estimated return on the investment of the purchase price for the specified option period. For example, an investment of $200,000 (the purchase price) at 5% (the estimated investment return) for six months (the option period) equals an option price of $5,000. The option provides you with control for the specified time.

Nonprofit developers should carefully examine all offers of donated property they receive. Serious environmental or structural problems often lurk in "free" properties.

Securing Financing Commitments

Once you have preliminary control of the property, it is time to start talking to lenders in earnest. To “cut a deal” successfully with a lender you must understand lending from the lender’s perspective. The lender wants to lend the maximum amount *and* to minimize risk. This is known as the lender’s dilemma.*

The Lender's Dilemma

If you have come this far, you are convinced that your project is important to the neighborhood and can succeed as you have conceived it. It is your job as the developer to convince the lender. Historically, most lenders have valued community involvement to some degree. Today, the federal Community Reinvestment Act (CRA) mandates such involvement. A variety of activities qualify as community involvement and meet CRA requirements, and your project may be one of them.

Although lenders are now considering more community-related loans, your approach to financing should, first and foremost, focus on the good business sense your project makes.

** For more on working with conventional lenders, see another guide in this series,* Mortgage Lending: An Introduction for Community-Based Organizations.

No matter how compelling it is, lenders will not consider your project if it is poorly conceived or presented. CRA will help get the lender's ear, and may even get you in the door, but the project must be financially sound, and you have to sell it. The two most important considerations for lenders are the return on investment and the degree of risk. If the developer is the "imaginative risk-taker," the lender is the "stabilizer."

The two critical considerations for lenders are return on investment and degree of risk.

If problems occur during construction, the lender stands to lose the yield on funds advanced, and possibly part of the principal. The finished product may not command the price on the market that the developer projected. If the developer then defaults on the loan, the bank may not be able to recoup its investment at foreclosure. And finally, lenders contend with interest rate risk, having committed funds at one rate when their own cost of funds (lenders borrow money, too) may rise much higher.

Regulators have required many lenders to tighten their lending requirements following the recent surge of bank and savings and loan failures. Tighter lending criteria have resulted in closer scrutiny of projects. Be prepared to provide sound explanations and detailed data to support your intentions.

The Proposal

How, then, do you convince a reluctant lender to fund your project? Much like a single-family mortgage application, some basic documents and information makeup a development proposal to a lender. A proposal should be bound and should include:

- a one-page executive summary, including the project's title, the names of its participants (the developer, the architect, the contractor, and any other professionals), and the terms and conditions of your loan request (see the sample on p. 29);
- a market study summary narrative;
- an income and expense statement, an income tax analysis, a cash flow analysis, a sales proceeds analysis, and a sources and uses statement;
- details of the proposed financing structure;
- construction cost estimates;
- architectural renderings and drawings of basic layouts and elevations;
- a site and location map;

- zoning information;
- photographs of the property;
- a copy of the option, if there is one;
- an appraisal. (Even though lenders tend to be suspicious of appraisals developers bring with them and will order a separate one, you need an appraisal for your own information.)

Also include a narrative describing your organization, profiles of your key staff members, and documentation of your track record in the neighborhood, including numbers of clients served and size and number of projects completed, as well as dollars of reinvestment. The lender will use this information to assess management capabilities and effectiveness.

The more of this information you bring to your conversations with the lender, the more comfortable the lender will be with your ability to carry out the project. Your presentations should be professional and organized (it's a good idea to rehearse them), no longer than 15 minutes initially, and clearly state what you are requesting from the lender. If you go in with less than polished drawings, narratives, and figures, you run the risk of not being taken seriously. This package costs some money, but fees such as the architect's can be built into the loan.

Types of Financing

The five basic elements of any financing structure for a real estate development venture are:

- equity;
- acquisition financing: land or building;
- land development financing (for raw land);
- construction financing;
- permanent financing**("takeout").**

Theoretically,**a** developer could go to a different source for each of these components, but more typically two or more of the loans will be combined in a single loan, or at least offered by the same lender.

Equity

Equity is the capital the developer or investor puts into the deal. A lender may require equity equaling up to 25% of total costs from a professional developer. The riskier the deal, the higher the equity requirements.

If the lender accepts the proposition that the value of the completed project will significantly exceed its development costs, the lender may accept a creative equity arrangement, where the developer provides no equity. The projected difference between the value and the costs is the developer's creative equity. Such an arrangement is usually possible only when a long-standing relationship exists between the developer and the lender.

Equity is the capital a developer puts into a project.

Equity is obviously a big problem for the nonprofit community organization. Its deal will be considered risky, often consisting of an inexperienced developer with a project in an area that lacks healthy development activity. Yet, the community organization does not have a lot of cash to put into a deal as its equity. Potential solutions include:

- seeking capital grants from foundations;
- entering into a joint venture where your partner or investor provides the cash and you provide the management;
- getting the properties donated and using them as your equity;
- syndicating with national, regional, or local syndicators;
- applying for funds from equity assistance programs such as the Enterprise Social Investment Corporation and the National Equity Fund.

Equity from syndication using the low-income **housing tax credit** is not a magical cure for the problems of equity financing for multifamily housing. Syndication in this instance consists of a limited partnership of investors who provide the required equity, primarily for tax advantages. Low-income housing tax credit syndications can be extremely difficult to put together. Among the many complex questions they raise are: How much equity will the syndicator raise? When and how will it be paid to the developer? Who gets the cash flow? Who incurs the risk of ensuring future rental rate compliance? What happens when the investors want to be removed from the deal after 15 years? Who manages the properties, chooses tenants, and controls rent levels, reserves, and cash flows?

Many of these strategies carry serious legal or tax consequences. The value of tax credits, for example, is depleted after 10 years, but the low-income use restrictions continue. The activi-

ties and tax status of a partner in a joint venture can also affect a nonprofit's 501(c)3 status and tax liability.

Without a very understanding lender or a generous donor, equity can be a tough nut to crack.

Land or Property **Acquisition**

Financing for the purchase of the property maybe advanced by the lender all at once or in stages as parts of the project are completed or new sections of the land (or new buildings) are acquired from the owner.

Land Development

This finances the preparation of land for construction, including engineering and permit fees and the costs of clearing and grading, performing soil borings, constructing storm drains and roads, and locating utility and water and sewer lines. Land acquisition and land development loans are frequently combined into a single short-term loan that is drawn in stages as land is purchased and work progresses. Interest is paid on the outstanding balance, which is reduced by the permanent financing or unit sale.

Pre-selling development projects helps developers avoid **disaster.**

Although in the 1970s and '80s developers often worked on "speculation," building portions or sections of a development without having lined up customers, current practice is to pre-sell most of the development to avoid losing the investment if the market crashes.

Construction

This short-term, interest-only loan finances the construction or rehabilitation of a building and is advanced in stages according to a predetermined draw schedule (see the samples on pp. 39-40). Costs usually included in the construction loan include architect's and attorney's fees, insurance premiums, the cost of surveys and permits, and taxes due during the construction period. If you need to hire consultants to manage the project, arrange a syndication, or secure financing, include their fees as well. Construction period interest can also be rolled into the loan.

When the developer intends to retain ownership of the project, a construction loan can be combined with permanent financing in a construction/permanent loan. The developer pays interest only on the funds advanced during the construction period at a short-term interest rate. At the end of that agreed-upon period, payments begin on the total loan at the permanent, usually lower, monthly payment rate.

The developer runs the risk of the lender demanding payments on the full loan amount at the end of the construction period, typically a year or 18 months, whether or not construction is completed and units are sold or rented. Developers can be forced to make payments out of their own pockets until the revenues begin coming in.

Permanent Takeout

This is the final, long-term loan on the project. If the developer of a rental project has secured permanent financing from a different lender, the permanent takeout loan is used to pay off the construction lender. The developer or owner of the project then begins making payments on the long-term (usually 30-year) loan.

A for-sale housing developer typically lines up a source of permanent mortgage financing for the future buyers, paying points to lock the lender into a favorable interest rate. The buyers get their mortgage loan from the permanent lender, and the developer takes the proceeds of each sale and pays off the corresponding portion of the construction loan.

Special Financing

Sometimes the type, nature, and complexity of a project require special financing.

Bridge Financing

Abridge loan provides financing between the end of one loan (usually a mortgage) and the beginning of another. Typically short-term, bridge loans can cover, for example, an outstanding construction loan while the developer renegotiates better terms than previously agreed upon for the permanent financing. In many tax credit projects, the syndicator agrees to pay the equity over several years and bridge financing is arranged to complete the project.

Gap Financing

The difference between the total amount of the project budget and the amount of the permanent financing is referred to as a gap, which is filled b**gap financing. In** affordable housing development, this is usually a subsidy.

Subsidies

In addition to conventional loans, most housing developments targeted to the low- and moderate-income marketplace are financed by a variety of federal, state, and local government financing, "soft money," subsidies, and grants. Sources include community development block grants, HOME funds, housing trust funds, arbitrage and reserve funds from bond sales, surtax charges, Section 108 loans, and the Federal Home Loan Bank Affordable Housing Program and CIP Advance Program.* It is beyond the scope of this guide to detail the many

** These programs are current at the time of printing, but regulatory programs are always subject to change. Check the* Housing and Development Reporter *for current programs. For a good summary of information on federal programs, see Lesley Slavitt,* Preserving and Revitalizing Older Communities: Sources of Federal Assistance *(Washington, D.C.: U.S. Government Printing Office, 1993).*

ways these deals can be constructed, but there are basic principles or techniques that are common to most packages.

Your first pro forma calculations give you an idea of how large a subsidy you will need. In these days of scarce public finding, subsidies usually take the form of "leveraging," combining public with private money. Some basic leveraging techniques include:

■ Find a front-end capital grant and borrow less from a conventional lender.

■ Use a grant as a **soft second** (a second mortgage on which no payments are due). Principal comes due later or is forgiven overtime.

■ Use a grant to subsidize (reduce) the lender's interest rate. In this case, grant funds are deposited with the lender to offset the difference between the market rate and the subsidized rate the lender agrees to charge.

■ Use tax-exempt financing such as housing development bonds (HDBs). The lender lends the money for the project to the local government. Because it is a program to benefit the public—in this case, low- and moderate-income buyers—the interest the lender receives is exempt from taxes. Therefore, the lender can offer a lower interest rate.

These are standard financing techniques. Your role as developer is to find the funds and negotiate how to combine them with conventional financing. It is important to consider a range of techniques and work with lenders to develop structures with which they are comfortable.

The Fern Hill Apartment Project

The following examples illustrate the executive summary, the sources and uses of funds, and the project schedule for Fern Hill Apartments, an imaginary 16-unit rental project. The lender will review these figures and use them to monitor the progress of the project.

The sources and uses statement makes a first attempt at determining the total project cost and total financing based on the preliminary use of the back-out method. The figures show that the projected rents will not cover all development costs. To makeup the difference, possible subsidies are added at this point. If no subsidy is available, the equity must increase, the rents must be raised, or both.

Executive Summary: Fern Hill

Project:	The acquisition, "gut" renovation, and conversion of an existing 16-unit, under-utilized building located at 123 East Market Street in the Highland neighborhood of Mytown, Mystate, to affordabletwo-bedroom units with all new appliances, individual electrical, HVAC, plumbing, and finishes.
Start date:	May 1994
Finish date:	February 1995
Developer:	Highland Affordable Housing Association, a qualified 501(c)3, Mytown, Mystate
Architect:	Quality Design Associates, AIA, Mytown, Mystate
Construction Management:	HAH Inc., Mytown, Mystate, a subsidiary of Highland Affordable Housing Association
Construction:	Delong Construction, Mytown, Mystate
Total project costs:	$816,197
COMMITMENTS	
Developer equity:	$29,479
City of Mytown Community Development Department:	$85,000
Mystate Housing Finance Agency:	$212,500
REQUEST	
Financing of:	$489,218
Terms:	30
Interest:	7.25%
Points/fees (150 basis points total)	1.50%

Sources and Uses Statement: Fern Hill

		Project totals	Per unit totals
1	USES		
2	Purchase		
3	Land acquisition	$35,000	$2,187
4	Building acquisition	85,000	5,313
5	Construction costs (hard costs)		
6	Construction	421,600	26,350
7	Construction contingency	42,160	2,635
8	Site improvement and landscaping	7,500	469
9	Interest expense	13,008	813
10	Construction loan: points and fees	7,316	457
11	Architectural and engineering	32,000	2,000
12	Permits and fees	4,000	250
13	Development costs (soft costs)		
14	Permanent loan: points and fees	7,338	459
15	Environmental survey	5,500	344
16	Property survey	3,500	219
17	Title and recording	3,750	234
18	Taxes	8,000	500
19	Appraisal	4,500	281
20	Legal	15,000	938
21	Accounting	5,000	312
22	Marketing/market study	5,000	312
23	Insurance	4,000	250
24	Developer's general and administrative	40,810	2,551
25	Developer's fee	61,215	3,826
26	Post-construction audit	5,000	312
27	Other/miscellaneous	0	0
28	Total project cost	$816,197	$51,012

		Proposed financing	Financing/unit
29	SOURCES		
30	Equity from developer	$29,479	$1,842
31	First mortgage	489,218	30,576
32	Second mortgage	0	0
33	Grant/other	85,000	5,313
34	S/LHRA	212,500	13,281
35	Total financing	$816,197	$51,012

Project Schedule: Fern Hill

1	USES	Amounts	May 94	June 94	July 94	Aug 94	Sept 94	Oct 94	Nov 94	Dec 94	Jan 95	Feb 95	TOTALS
2	Purchase												
3	Land acquisition	$35,000	$35,000	$0	$0	$0	$0	$0	$0	$0	$0	$0	$35,000
4	Building acquisition	85,000	85,000	0	0	0	0	0	0	0	0	0	85,000
5	Construction costs (hard costs)												
6	Construction	421,600	0	0	70,267	70,267	70,267	70,267	70,266	70,266	0	0	421,600
7	Construction contingency	42,160	0	0	7,027	7,027	7,027	7,027	7,026	7,026	0	0	42,160
8	Site improvement and landscaping	7,500	0	0	1,875	1,875	0	0	0	1,875	1,875	0	7,500
9	Interest expense	13,008	0	0	0	2,168	2,168	2,168	2,168	2,168	2,168	0	13,008
10	Construction loan: points and fees	7,316	0	0	7,316	0	0	0	0	0	0	0	7,316
11	Architectural and engineering	32,000	7,500	0	2,500	7,500	2,500	1,500	1,500	1,500	7,500	0	32,000
12	Permits and fees	4,000	0	0	4,000	0	0	0	0	0	0	0	4,000
13	Development costs (soft costs)												
14	Permanent loan: points and fees	7,338	0	0	0	0	0	0	0	0	7,338	0	7,338
15	Environmental survey	5,500	5,500	0	0	0	0	0	0	0	0	0	5,500
16	Property survey	3,500	3,500	0	0	0	0	0	0	0	0	0	3,500
17	Title and recording	3,750	1,875	0	0	0	0	0	0	0	1,875	0	3,750
18	Taxes	8,000	4,000	0	0	0	0	0	0	0	4,000	0	8,000
19	Appraisal	4,500	4,500	0	0	0	0	0	0	0	0	0	4,500
20	Legal	15,000	5,000	0	0	5,000	0	0	0	0	5,000	0	15,000
21	Accounting	5,000	1,000	0	0	0	0	2,000	0	0	2,000	0	5,000
22	Marketing/market study	5,000	5,000	0	0	0	0	0	0	0	0	0	5,000
23	Insurance	4,000	1,000	0	0	0	0	2,000	0	0	1,000	0	4,000
24	Developer's general and admin.	40,810	0	5,830	5,830	5,830	5,830	5,830	5,830	5,830	0	0	40,810
25	Developer's fee	61,215	0	0	0	0	0	0	0	0	61,215	0	61,215
26	Post-construction audit	5,000	0	0	0	0	0	0	0	0	5,000	0	5,000
27	Other/miscellaneous	0	0	0	0	0	0	0	0	0	0	0	0
28	Totals	$816,197	$158,875	$5,830	$98,815	$99,667	$87,792	$90,792	$86,790	$88,665	$98,971	$0	$816,197
29	SOURCES												
30	Equity from developer	$29,479	$29,479	$0	$0	$0	$0	$0	$0	$0	$0	$0	$29,479
31	First mortgage	489,218	0	0	0	0	0	0	0	0	489,218	0	489,218
32	Second mortgage	0	0	0	0	0	0	0	0	0	0	0	0
33	Grant/other	85,000	0	0	0	0	0	0	0	0	85,000	0	85,000
34	S/LHRA	212,500	0	0	50,000	50,000	50,000	50,000	0	0	12,500	0	212,500
35	Totals	$816,197	$29,479	$0	$50,000	$50,000	$50,000	$50,000	$0	$0	$586,718	$0	$816,197
36	Construction loan	$487,747	$129,396	$5,830	$48,815	$49,667	$37,792	$40,792	$86,790	$88,665	($487,746)	0	$816,197
37	Loan draw		(129,396)	(135,226)	(184,041)	(233,708)	(271,500)	(312,292)	(399,082)	(487,747)	0	0	816,197
38	INTEREST CALCULATION												
39	Monthly interest factor	0.00604	(782)	(817)	(1,112)	(1,412)	(1,640)	(1,887)	(2,411)	(2,947)	0	0	
40	Total interest	($13,008)											

Explanation of Line Items: Sources and Uses Statement

This statement is divided into two main sections. The “Sources” section identifies where the funds are coming from and normally lists all financial participants, both debt and equity. The “Uses” section lists where the funds are going and is traditionally divided into three sub-areas: purchase (acquisition), construction (hard costs), and development (soft costs).

1 Uses: items included in this section depend on the project and include all costs anticipated in completing a project.

2 Purchase: cost of acquiring the land or land and building. This section is usually sub-divided into land and building sections.

3 Land acquisition: cost allocated to land. Landis an asset and is accounted for separately. The land purchase price is the accounting basis for the asset.

4 Building acquisition: cost allocated to the building. This asset is depreciable, and is accounted for separately. Depreciation is the annual reduction of the building purchase price to reflect wear and tear from use.

5 Construction costs (hard costs): estimated costs to be incurred during the construction phase of a project.

6 Construction: estimated costs associated with the “bricks and sticks,” or the actual product production.

7 Construction contingency: amount set aside to pay for any unanticipated construction costs.

8 Site improvement and landscaping: estimated cost of land improvements such as grading, seeding, sidewalks, trees, and shrubs. The value of the improvements is added to the basis of the land purchase price.

9 Interest expense: estimated amount of interest to be paid for borrowed funds during the construction process.

10 Construction loan: points and fees: estimated up-front costs paid to the construction lender for making the loan.

11 Architectural and engineering: cost of the design and production of drawings, specifications, and related construction documents.

12 Permits and fees: cost of inspection, plan review, and zoning compliance, paid to the administering government agency .

13 Development costs (soft costs): costs normally paid before and after construction.

14 Permanent loan: points and fees: estimated up-front costs paid to the lender for making the permanent loan. This loan is normally used to pay off ("take out") the construction loan.

15 Environmental survey: required by most lenders before they will commit to financing. Completed and paid for early in the pre-development phase, it is a reimbursable development cost. Often called a "phase one environmental."

16 Property survey: required by most lenders prior to giving a commitment for financing. Completed and paid for early in the pre-development phase, it is a reimbursable development cost.

17 Title and recording: costs associated with closing the permanent loan and recording the documentation.

18 Taxes: amount paid to an escrow account at closing for taxes. If property taxes have to be paid during construction, taxes should also be listed under the construction section.

19 Appraisal: an evaluation report ordered by the lender and paid for by the developer. Must be approved by most lenders before they will commit to financing. Completed and paid for early in the pre-development phase, it is a reimbursable development cost.

20 Legal: attorneys' fees for review of documents, preparation of contracts, loan closing, and other services, usually paid in several payments. Varies widely based on type of project.

21 Accounting: costs of setting up and allocating a system for the income and expenses associated with the project.

22 Marketing/market study: a report paid for by the developer and completed and paid for early in the pre-development phase, the market study is a reimbursable development cost. Marketing is the advertising and promotional costs of leasing or selling the project.

23 Insurance: predetermined amount paid to the escrow account at closing to cover the cost of insurance for project owners. May also be required during construction if not covered as part of the developer's insurance.

24 Developer's general and administrative: developer's reimbursable expenses associated with the production of the product: office, staff, equipment, travel, supplies, and other costs.

25 Developer's fee: funds paid to the developer for expertise, to offset risks, and to provide a return on equity.

26 Post-construction audit: fees paid for a final accounting of the project costs.

27 Other/miscellaneous: amount set aside to pay for any unanticipated development costs.

28 Total project cost: estimated cost of producing the product.

29 Sources: providers of funds, both debt and equity, and the amounts provided by each.

30 Equity from developer (owner): funds provided by the developer and/or the owner. Varies based on project.

31 First mortgage: funds usually provided by the permanent lender.

32 Second mortgage: funds from a lending source that are subordinated to the first mortgage.

33 Grant/other funds provided by various finding sources.

34 State/local housing or redevelopment agency: funds provided by state or local government sources.

35 Total financing: all funds allocated.

Explanation of Line Items: Project Schedule

The project schedule is also a "first cut," with lines 1–35 the same as the line items on the sources and uses statement. The developer projects the payment of the "Uses" line items and the receipt of "Sources" line items over an anticipated time period to complete the project. The costs and funds are allocated monthly based on the developer's knowledge of the development process and the financing available. Costs and funds are totaled monthly on lines 28 and 35.

36 Construction loan: total amount borrowed (first column) to cover development costs. The monthly columns show the monthly draw against the loan. Note that the loan is paid off in January 1995. The difference between line 28 and line 35 is the amount of funds either available or required to pay that month's costs. If line 28 is more than line 35, funds must be borrowed (construction financing).

37 Loan draw: the difference between line 28 and line 35 plus all preceding draws. The monthly totals are cumulative, so at any point the total loan outstanding can be determined.

38 Interest calculation: amount of interest paid on the outstanding monthly balance as the loan is drawn down.

39 Monthly interest (factor): this fraction in the first column is determined by dividing the interest rate (0.0725) by 12. The monthly interest factor is multiplied by the amount of the monthly loan draw (line 37) for each month.

40 Total interest: the sum of all the monthly interest payments (line 39).

Constructing the Project

You must decide what role your nonprofit organization will play in the construction of the project, the final step in the development process. You have two basic choices:

- act as the general contractor on the job;
- hire a general contractor and assume an oversight and coordinating function.

Acting as your own general contractor will not necessarily save you money.

Many groups assume that being their own general contractor will save them money. This is not necessarily true. Subcontractors who have existing business relationships with general contractors and anticipate future work from the "general" will make their bids competitively low. "Subs" who do not know the general contractor and figure that the job is a one-time deal may bid higher. If you have no contacts with subs or are undertaking the development as a one-time, unique project, you may save money by working with an experienced contractor who has established contacts.

Various contingencies can also drive the cost of construction up. For example, if prices for materials go up after the financing and bids have been secured, the general contractor will have to absorb the added costs, if you have a good contract. If you are the general, those costs become your liability. Contractors also have lines of credit with suppliers that can keep a job moving between draw payments.

The general contractor's price will contain a mark-up, which you should compare to your own staff costs. Consider not only the salaries of your construction or rehab staff, but the value of the other services they will not be able to provide when they are running the job.

General contracting is a separate business from development and in many areas requires spe-

cial licensing. Lenders, investors, or government participants in a project may also require a construction bond (a certificate that serves as evidence of the ability to complete the construction) which, for anew contractor, is difficult and time-consuming to secure. Bonding is usually provided by a bonding company at a cost of 2%-4% of the construction contract value. To secure a construction bond requires the developer to possess cash and assets in an amount the bonding company determines (usually through a "due diligence" process) to be adequate to cover the project.

State law or contract terms or both require general contractors to carry builder's liability and worker's compensation insurance, both of which are expensive for new companies. The delay resulting from securing insurance, licenses, and bonding may, in itself, counteract any potential advantage of acting as a general contractor.

Duties of Contractor

When considering whether to act as general contractor, carefully consider issues of your organization's capability, which are even more important than issues of cost. As the builder or general contractor, you must:

- secure all bids (on a rehab job this can involve as many as a dozen different trades);

- schedule all the work and make sure the subcontractors perform according to schedule (the electrician has to set his boxes, for example, so that the drywaller can come in and do her work);

- monitor the quality of all subcontractors' work;

- make sure all work complies with applicable building codes;

- order supplies and equipment and monitor costs;

- advance cash as necessary to keep the job moving while you wait for loan drawdowns;

- guarantee that you will be responsible for the quality of the work long after the project is finished.

Some basic guidelines can help you decide project by project whether you should act as the general contractor. The smaller the size of the project, the greater are your chances of success. The more concentrated the units geographically, the easier the process will be to manage. Also consider the job's complexity. If a rehab project requires only roofing, plumbing, wiring, and some painting, for example, it probably makes sense for you to deal with subcontractors

directly. And if you have good contacts with subcontractors and know they can, to a certain extent, coordinate their work, you can probably manage the job of general contractor.
If you have succeeded as general contractor on several simple rehab projects and have the staff time, you may be ready to tackle larger or more complex projects.

Construction Management

Even if you decide not to be the contractor and your functions on the job are more limited, you will still need a projector construction manager on your staff. Depending on the size of the project, this may be a full-time position, since your role as the developer still requires that you perform the following:

Whether or not you act as the general contractor, you'll need a project manager on staff.

- assemble the team: contractor, architect, lender, inspectors, and legal counsel;
- **review** plans, specifications, and budgets;
- coordinate various team members' activities (for example, get the lender and inspectors out when the contractor needs a draw);
- resolve problems (for example, the contractor has run into a huge boulder on the lot which must be removed, incurring a cost overrun-do you pay extra or do without the storm doors to makeup the difference?);
- make quality control inspections;
- monitor costs to make sure you are within budget and make adjustments and approve changes as necessary;
- monitor the progress of work to make sure it is on schedule.

Whether you subcontract for these services or use in-house staff, a project manager should have construction expertise and be organized, diplomatic, good with figures, and good at solving problems.

Construction Monitoring

Whether or not you act as the general contractor on a job, as the developer you will warrant to your lender that certain work has been done and request loan payments for that work, which will be made according to a draw schedule you and the lender develop. The draw schedule is the lender's way of controlling risk and can be the developer's tool for monitoring work and costs.

Each lender, including city government and state finance agencies, has its own particular kind of draw schedule. Two basic draw schedules can be constructed, one for small or new construction projects and the other for larger or rehab projects.

The first ties loan drawdowns to the completion of specific stages of construction (see sample draw schedule 1). At the completion of a phase, the developer asks the lender to inspect the project. If the lender agrees that it is complete, he or she releases the funds for that stage. This system lacks the flexibility necessary for larger projects, on which work could stall if the developer had to wait until completion of each stage before being paid. This draw system normally does not require a **retainage** (a portion of a draw request-usually 10%-lenders hold back to minimize their risk).

The second type of draw schedule reduces the risk of work stalling. The developer creates an itemized budget of hard costs and soft costs and the lender agrees to make regular monthly payments based on invoices and the percentage of work in place (see sample draw schedule 2, based on the Fern Hill project schedule). The developer can continue to draw some money regardless of the order in which the work is completed. The lender usually specifies a minimum and maximum amount per draw. This type of draw schedule requires more from the developer, who must estimate materials costs, labor time, and expenses. The developer warrants to the lender that a certain percentage of work has been done, and developers who miscalculate may end up having to cover cost overruns themselves. Many experienced developers have ended up with more money tied up in the project than they could ever hope to recoup through sales or leases because they did not watch their builders carefully enough.

Sample Draw Schedule 1: New Construction

Lot: AD-104
Address: 236 New Street
Construction Cost: $150,000

Draw #1 15%	foundation walls complete; building permit exhibited; location survey and surveyor's certificate furnished; builder's risk insurance obtained	$22,500
Draw #2 20%	rough framing package delivered; exterior walls framed; roof sheathed	$30,000
Draw #3 10?40	interior framing complete; windows in place; structure secured	$15,000
Draw #4 1570	plumbing, heating, and wiring rough-in complete; roof shingled	$22,500
Draw #5 10%	drywall hung and finished	$15,000
Draw #6 10%	interior trim in place; interior concrete complete; heating system in place	$15,000
Draw #7 10?40	interior painting complete; resilient flooring complete; hardware set; cabinets and vanities set; ceramic tile in place; plumbing, heating, and electrical fixtures installed	$15,000
Draw #8 10?40	all appliances installed; all floors complete, all exterior work complete; mechanic's lien waivers and occupancy permit received	$15,000

Sample Draw Schedule 2: Fern Hill Apartments

	Amount	Remaining Balance (to be disbursed)
Draw #1	$129,396	$358,350
Draw **#2**	$5,830	$352,520
Draw #3	$48,815	$303,705
Draw #4	$49,667	$254,038
Draw #5	$37,792	$216,246
Draw #6	$40,792	$175,454
Draw #7	$86,790	**$88,665**
Draw #8	$88,665	$0
TOTAL	$467,747	$487,747

Chapter 4
Post-Development: Operations

The final, post-development or operational phase includes the marketing, sales or leasing, and property and asset management of a project.

Marketing

You must begin to market the units before construction is completed. When to begin and who to have handle it are open questions for both conventional developers and neighborhood organizations. Marketing includes advertising, promotions, grand openings, and other activities aimed at selling or leasing the project. Although the marketing starts in the pre-development phase, marketing to the customer is a primary focus of the post-development phase, when final cost figures are reviewed and sale or leasing prices are adjusted, if possible, to reflect the changes.

Sales or Leasing

Most small developers do not have a real estate brokerage capacity in-house. Because their attention is focused on monitoring projects in process and developing new opportunities, they may choose to hire a real estate company to market the units. They may contract with a leasing service or hire their own staff person whose sole responsibility is to work at the project taking contracts or applications.

Begin marketing before construction is completed.

Since this function requires distinct sales talent, it is often performed by outside professionals, but the choice will depend largely on the project. Most community-based organizations could probably handle the marketing of, for instance, 10 or fewer rental units subsidized for low- and moderate-income residents. Referrals from the neighborhood, the city's Section 8 waiting lists, and some limited advertising will probably fill the units. If the nonprofit chooses not to retain management, a management company may handle the actual leases.

A neighborhood group may also be able to market owner-occupied units targeted to lower-income buyers. But since the requirements for the purchase financing result in a smaller pool of qualified applicants from which to draw, more advertising, more counseling of prospective applicants, and more time is usually necessary.

Some groups start out handling the marketing themselves, only to turn it over to a real estate agent later because sales are going so slowly. Agents are in touch with a much larger market than are neighborhood organizations.

Using a Real Estate Agent

If the project aims partly at stimulating reinvestment, then it may make sense to use a real estate agent anyway, even if you think you could sell the units. Using an agent encourages a return of healthy real estate activity to the neighborhood. Agents talk to each other, and they will bring more and more prospective buyers to your area.

The developer **and the** real estate agent often **share the costs of advertising.**

Whether or not you use a real estate agent, a typical marketing strategy is to concentrate on getting one or two units completed as soon as possible to serve as models. Then, approximately two weeks before the site is ready to be shown, advertise. Developers also put signs upon sites when they start to build or even sooner. However, if signs go up too early, they grow stale, and people no longer notice them by the time the developers are ready to offer contracts or leases.

If you do use the services of an agent, review with him or her the monthly sales projections you build into your cash flow pro forma. The agent then should furnish you with regular weekly reports on the level of traffic, who the clients are, the number of contracts signed, and the number of financing commitments secured. Monitor these reports closely, and if they are not meeting your projections, work out new advertising strategies or, if necessary, change agents. The developer and the agent often share the costs of advertising.

Managing Property

The developer is responsible for overseeing property management and makes decisions to enhance the performance of the investment, extend the economic life of buildings and their components, and continue to maximize return on asset. But the critical question for the neighborhood organization is whether or not to manage a rental project. This decision depends on organizational systems and staff capabilities, but even more it depends on the role your organization wants to play in the community.

Most property management companies assign five to seven projects to each manager, and a project might consist of 50 or 500 units. Clearly, economies of scale come into play. Property management requires a staff person to be on call 24 hours a day, but it is not necessarily full-time work day in and day out. In addition to patience and attention to detail, it requires good contacts with reliable maintenance and repair people. An organization with good record-keeping and financial systems and patient staff members can take it on.

The more thorny issue is whether property management is an appropriate role for your organization to assume. The property manager not only signs the leases, but also appears in court to evict tenants. And, despite the most careful screening and counseling, evictions will inevitably occur. This process is painful, especially for a group whose goal is to help low- and moderate-income people. Any organization that takes on property management must be absolutely willing to be closely identified with the project, with all the good and bad publicity that can entail.

Conclusion

When told of this guide's purpose-to help nonprofit community organizations decide whether or not to become developers—some for-profit developers said, "Why would they want to do that?'

Development is risky. A project that stalls or, worse, fails can damage an organization's credibility with finding sources and, more importantly, with the community. A successful project, on the other hand, can enhance your organization's image, help the community, and generate income.

No manual can cover all the myriad contingencies that can arise in the course of a project. And no guide can make you an expert developer-that comes only with working through several ventures. This guide should help you evaluate your organization's readiness to become a developer and decide whether you have the staff capabilities, clarity of purpose, track record, financial resources, and community support necessary to succeed. The important thing is to think the process through carefully at the beginning, making sure that everyone understands the risks as well as the benefits.

Good luck!

Glossary

Board of **Realtors** A trade group of local real estate licensees who are members of the state and National Association of Realtors and who may operate a multiple listing service and conduct educational activities.

bonding The process in which a bond company provides a formal certificate to a contractor that serves as evidence of ability to complete the construction.

bridge financing Short-term financing between the end of one loan and the beginning of another.

broker A state-licensed agent who acts for property owners in real estate transactions.

Community Reinvestment **Act (CRA)** A 1978 federal law requiring that lenders make efforts to meet the credit needs of all the communities they serve.

contingency The portion of the construction costs (usually 10%) developers add into their budgets to cover unforeseen expenses.

creative equity Zero equity contributed by a developer when a lender accepts the proposition that the value of a completed project will exceed its development costs.

draw A cash payment from a lender to a developer or contractor according to the terms and conditions of a construction loan.

equity In real estate development, the capital a lender requires a developer or investor to put into a deal; the amount of the project owned by the developer or investor. The amount varies according to the degree of risk the lender perceives the project to entail.

financial feasibility analysis Preliminary calculations a developer performs to assess whether the projected rents or sales prices of a project will cover the costs of developing the project.

gap financing Financing developers use (for community-based nonprofit organizations, typically a subsidy) to close the gap between the amount needed to complete the project and the amount of the permanent financing.

general **contractor The** entity engaged to constructor supervise a construction project, which includes securing bids, scheduling work, hiring subcontractors, monitoring costs, and guaranteeing the quality of the work.

hard costs The costs associated with the construction phase of a project.

joint venture An agreement between two or more parties to invest in a single project.

low-income housing tax credit Internal Revenue Service-regulated tax credits used to raise equity, as defined by the 1986 tax reform act.

market study The gathering and analysis of market data of a given area, including information on population, home ownership, vacancy rates, sales and rental data, competition and amenities. Used to develop projections and make proposals to lenders.

multiple listing service (MIS) An association of real estate brokers that agrees to share sales listings with each other and which frequently distributes a book with all the listings to its members.

option An agreement whereby a potential buyer purchases the right to buy a property within a predetermined period of time for an agreed-upon price.

phase one environmental study A preliminary analysis of a property performed by a certified engineer to test for a variety of pollutants, including radon, asbestos, and lead-based paint.

plugs Factors that developers "plug into" pro formas for the purpose of projecting expenses.

pro forma The presentation of data where certain amounts are hypothetical. In development, usually a financial statement that shows what is expected to occur.

retainage The portion of a draw request (usually 10%) held back by lenders to reduce their risk.

soft costs Costs incurred before and after the construction phase.

soft second A second mortgage loan on which the principal is deferred or forgiven over time.

subcontractor A worker such as an electrician, painter, or roofer who performs services under contract to the general contractor.

syndication A means of raising capital or equity by selling interest in a property to investors, usually to provide the investors with certain tax advantages.

takeout financing A commitment to provide permanent financing following construction of a project. This commitment is usually contingent on specific conditions for the permanent loan to “take out” the construction loan.

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